

## The Georgetown Proposals

By HARVEY L. PITT\*

This is something of a novel experience. It is sort of like standing before you and condemning the dead which in one sense compels me to speak in somewhat reverent tones just in case. I really prefer not to disturb what is lying in the grave. The Georgetown Proposals have been denied and it is unlikely in my view that they will be resurrected, despite contrary assertions from some at the Commission. For example, Commissioner Evans has speculated that if the Kutak report (the proposed Model Rules of Professional Conduct) is not adopted in its present form, the Commission might revisit the Georgetown Proposals. This suggests to me that some of the things that the SEC has said about the Georgetown proposals may give us some cause for concern. I would like to make a couple of opening caveats and then briefly tell you what some of the problems are with the denial. Even though the matter has been denied, the Commission has given us a significant insight into some of its reasoning process and not all of it is very hopeful or helpful.

First, I would like to echo what Ralph Ferrara said in that I think everyone should read the Kutak report<sup>1</sup> for himself. Some of what I heard described is not what I have read and I think it is important to realize that some of the provisions covering when a lawyer is compelled to go or should go beyond a client are caveated with such extreme standards as to avoid the creation of an absolute liability. Also, contrary to what has been said, I commend to your attention a letter that was prepared under the auspices of Don Evans by the Committee on Professional Responsibility commenting on the Code which has very constructive suggestions for revision of a variety of the terms of the Code, in particular Rule 1.13.

The question has been asked as to why the Georgetown Proposals are such a big issue? How they came to pass? And what the SEC said when it rejected them? Very briefly, the two petitions filed as the Georgetown Proposals were an effort by a self-styled public interest group which is not known as the Georgetown group but as the Institute for Public Interest Representation and which is loosely affiliated with the Georgetown University Law Center.

The first petition was filed in May of 1978 and basically sought to amend Rule 2(e) of the Commission's Rules of Practice. It would have defined the duties of an attorney once he learns of his client's fraud where the fraud is clear. Unfortunately, fraud was defined as any material misrepresentation or the omission of a material fact and one need only to look at the recent *Daniel* Supreme Court decision to find that even the Supreme Court thinks that the

\*Member of the District of Columbia and New York bars.  
1. 48 U.S.L.W. No. 32 (BNA) (Feb. 19, 1980).

disclosure obligations of the federal securities laws are vague and ambiguous. The four steps that involve an attorney's duty are informing the client, asking the client to rectify the fraud, revealing the fraud to affected persons if no rectification occurred and finally informing the SEC of any frauds or securities violations once the lawyer becomes aware that the fraud has in fact been committed. In this process, one has to start with the assumption which Milton Freeman described, in terms of the SEC's initiatives in the filing of this proposal. Another issue, of course, is what authority the SEC has to implement these kinds of proposals—an issue the SEC did not tackle either when it denied the May petition or the supplement thereto.<sup>2</sup>

Shortly after the May petition was filed, its draftsman left his position at the Institute and was replaced by Charles Halpern who came in and filed a supplement to the May petition in November. The use of the term supplement is a misnomer because the Commission actually treated them as separate petitions. In fact, I think, although I am not privy to this, that there must have been an agreement that they could do so because the Commission's procedures in dealing with both petitions are highly disparate and suggestive of at least some attempt to reconcile the problems created by the petitions. The November supplement attempted in part to clarify what was meant by the ways in which an attorney had to call upon a corporate client to correct the fraud. However, the clarification really did not do much to help the problems created by the initial proposal. The November petition stated that the lawyer was required to bring facts and legal implications to the attention of management and then, if not satisfied with management's response, to the client's board of directors. But, thereafter, the petition was ambiguous and it provided that the determination as to when appropriate action should be taken was something to be determined by the lawyer and not the client or by any objective standards.

The November petition also had some very interesting disclosure requirements. It would have required corporations to have the board instruct every attorney working for the corporation to report actual or probable violations of the federal securities laws to the board. The board was required to authenticate compliance with this directive by filing in its Form 10-K and its annual report to shareholders a certificate which showed that (1) the board had given the necessary instructions to all of its attorneys; (2) all attorneys had indicated their compliance with the board's directives either by reporting such violations or reporting that none existed; (3) the board had considered the attorneys' reports and taken appropriate action, whatever that might be, in response to those reports; and (4) the corporation's independent auditors were advised of any of the reports that had actually been filed. In addition, the proposals would have required all 1934 Act registrants to file with the Commission copies of all written agreements delineating the relationships between the

2. [1979 Trans. Binder] Fed. Sec. L. Rep. (CCH) § 82,144.

company and attorneys it retains. If read literally, this seems to include retainers for just about every possible and conceivable purpose. The required materials were to include the frequency and the nature of outside counsels' contacts with the board, chief executive officer, general counsel and independent auditors and the duties of outside counsel upon discovering illegal activity. There was also a discretionary provision which would permit outside counsel and the board to disclose any other contacts with outside counsel that it might see fit to do in a spirit of cooperation with the underlying theme of the proposals. Finally, item four of the proposal would have required that resignations or dismissals of attorneys be reported in a Form 8-K just as they are for auditors at the present time.

It is important to point out that the petition raises significant questions as to where the SEC's authority lies. In my view, the most troublesome aspects of the petition are not that it was published and not that the proposals were far reaching. Rather, in my view, the frightening prospect is that some of these requirements could be placed in the ambit of SEC authority and that the Commission declined to evaluate that issue and give comfort as to what it perceived the proper role would be for the agency with respect to the future establishment of professional responsibilities. I think this is unfortunate because it leaves people in a great state of flux and doubt as to what the development of the law will be. Moreover, I think one has to read the denial of the petition in the context of Commissioner Evans' remarks delivered some two weeks after the petition was denied to get a flavor for the views that at least 20 percent of the commissioners have articulated in this context.

I also believe that one must have a perspective. It is useless to rail against what the Commission has done or has not done. Instead it is more constructive to approach this issue with the bifurcated analysis that the Commission itself has attempted to employ, one with which I think most of the speakers here, with at least one notable exception, might disagree. This analysis entails the distinction between a lawyer as an advisor and a lawyer as an advocate. It is one thing to attack these proposals and the SEC's authority after a client has been sued and to defend the client's position. It is quite another thing when one is attempting to counsel lawyers both within one's firm and outside one's firm and also to counsel corporations as to what their responsibilities may be. And in that sense I think we are all fooling ourselves if we do not pay a great deal of attention to the principles that the SEC is articulating.

I am, in a couple of enforcement proceedings, representing attorneys who are the subject of investigations and it really is not of much comfort that we may have a litigable case and we may prevail after the lawsuit is brought. I find the whole process to be one of rather serious disquietude and it is obvious that the impact on the individuals involved is extremely great. In that sense, I agree with Arthur Mathews, that lawyers are not entitled to any greater consideration than anyone else but they certainly should not be entitled to any less. I think it is important to bear in mind we are talking about situations that

call for at least some insight as to where the agency is headed and some of the things it may be doing.

The Commission's procedure in denying the petition, as I said at the outset, were disparate and therefore indicative of a bifurcation approach. The Commission denied the May petition almost a year after it was filed, offering seven basic reasons which, in my view, are troublesome.<sup>3</sup> The November petition was the subject of full public comment before being denied. It is at least questionable how the Commission could deny the May petition as to which the November petition was a supplement and yet permit the November petition to go out for comment by itself. Nevertheless, this is what the Commission did. The seven reasons that the Commission gave for its denial of the May petition are surprisingly applicable to the November petition. However, they were not employed in the same way and in the same fashion. First, the Commission decried the complexity of the issues that had been raised by the petition. Second, the Commission stated that the delineation of attorneys' responsibilities should occur as a result of specific injunctive or Rule 2(e) proceedings. This is hardly a source of comfort to the bar if there is concern that the SEC should not be conducting *ad hoc* enforcement proceedings. Moreover, the definition of these responsibilities would still be a disputed matter whether or not the SEC has authority since *ad hoc* enforcement is the worst way to approach this area. Third, the Commission suggested that this is an evolving area and that generic proceedings are premature. Many of us have heard that argument in other contexts but that is one of the reasons why Congress granted agencies rule-making authority. Again, the Commission's authority with respect to the subject is a debatable matter. Fourth, the Commission stated that specific actions were pending including the famous or I should say infamous *Carter-Johnson*<sup>4</sup> proceeding, the resolution of which the Commission said may impinge on the rule-making issues that were before it. The SEC found it essentially not productive to engage in a parallel consideration of the same issues. I think many members of the bar given their choice as to the form of proceeding would have opted for the one the Commission rejected.

Fifth, the ABA's reevaluation of the Code of Professional Responsibility was cited as a matter that might affect the resolution of these issues and the Commission felt it should neither duplicate the ABA's efforts nor proceed without the benefit of the ABA's conclusions. This presents a cause for concern because it suggests that the Commission may revisit the issue after the ABA's work is completed. This would be even more likely if the Kutak draft was substantially altered or watered down, since there is strong Commission sentiment and support for the Kutak draft as it now stands. This would seem to be pure speculation on my part except that Commissioner Evans has

3. [1979 Trans. Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,144.

4. *In re Carter*, [1979 Trans. Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,175.

made this explicit. Sixth, the SEC simultaneously published the November petition for full public comment. How that was a basis for the denial of the May petition is not clear to me and was not explained in any of the documents I was privy to read.

Finally, the May petition, the Commission stated, was attenuated with respect to the disclosure requirements. The Commission found that these suggestions were not like "traditional rule-making efforts" it has undertaken in the field of corporate governance. This suggests that the Commission views efforts to establish attorney responsibility in the form of the Georgetown petition or other similar matters as merely an adjunct of the question of corporate governance. This is something that I think some members of the bar would question and take issue with. When the November petition was published for comment, the Commission said that it was publishing it to focus public attention on an important issue of corporate governance, which again reiterates the Commission's belief that attorneys' standards of conduct are a part of the issue of corporate governance.

The Commission also said that the publication would alert attorneys to their responsibilities under current law. If you think about that statement for a moment, it appears to contain an implicit ethical judgment on the terms and contents of the petition. The rational justification to the Commission's publication was the Commission's presumed desire to publish the document to satisfy the courts, if ultimately sued, that it had given due consideration to the petition and rejected it after carefully considering and obtaining the views of affected persons in the public sector. However, one still has to be troubled by the suggestion that this would alert attorneys to their responsibilities under current law because it suggests attorneys are not already alerted to their responsibilities under current law. This may explain the derivation of some of the strength of the comments that Milton Freeman bestowed upon us earlier during this program. This is not something that requires very much reading between the lines; the Commission is being rather explicit in its statements.

Finally, the Commission said that it would encourage boards of directors to review the proper role of attorneys. And I think the criticisms I just articulated with respect to the Commission's comment about alerting attorneys to their responsibilities are comparable with respect to the notion that boards of directors need to be alerted and encouraged to review the attorneys' proper roles. I am not making the assumption that these are not useful goals or that the petition could not serve a valid purpose, but it is the Commission's method of proceeding which has engendered some of the comments the Commission has received about its publication. I think that it could have been done in a less dramatic and less drastic fashion.

A minor note for SEC watchers is that the petition appeared to be assigned to the unit in the division of corporation finance charged with corporate governance issues as opposed to the general counsel's office. This is not to say that the general counsel's office did not have a role in it, but the interested

persons to be contacted were persons who deal with corporate governance disclosure issues. That, in itself, suggests that some of the issues raised in the November petition were of a different kind than in the May petition. Among the issues flagged for comment was a need for and the desirability of the proposed rules and then at long last the suggestion of the possibility that maybe the SEC might lack the authority to proceed. As I indicated earlier, that is a result that was not reached in connection with the May petition and I am not certain that the Commission in good faith could have suggested it lacked authority.

The Commission denied the November petition on April 30th of this year,<sup>5</sup> but left open several major issues. First, it wrote in footnote four of the letter containing the denial that the Commission does not have to pass on whether it has the authority or not. Obviously, one advantage for the Commission not to have passed on the authority issue is that if it clearly stated it lacked authority, the petitioners would have had a free pass to the courts to have the SEC reversed on this ground. Thus, the Commission's action again was not without rational basis. Second, the Commission did not expressly embrace the criticisms reached, but it appears to have relied on them. That ambiguity is troublesome because some of the criticisms were exceedingly valuable and the kind of comments that militate against the adoption of the specific provisions that have been put forward. Third, the Commission said that it would continue to monitor efforts of the private sector and that if the Commission is not satisfied with what it sees, it may take further action. That is an issue that unfortunately, in my view, should not have been left open. Fourth, the Commission left open what type of disciplinary and enforcement proceedings against professionals the Commission would undertake in the future to effectuate the proposals rejected on a generic basis. Of course, one can assume that the Commission will wait for the outcome of the *Carter-Johnson* proceedings and the ultimate court challenges that ineluctably will ensue. Finally, the Commission talked about future rule-making, stating that it leaves open the possibility that it may engage in rule-making "in this area in the future."<sup>6</sup> Query as to whether that statement is consistent with its statement that it had not decided its authority or can it be viewed as an SEC assertion of its jurisdiction?

In regard to the issue of the Commission's authority, the Commission's November denial was much more limited than the May denial. The reasons given are encouraging, but again as I indicated, they were not expressly embraced by the agency. The Commission cited the conclusion of commentators that there was no showing that existing information systems had proved inadequate or that boards have been precluded from obtaining any information they desire. But still, the Commission stated that this might help

attorneys focus on what their responsibilities were and might help boards focus for the first time on the appropriate method of obtaining information up through the corporate system. This appears to be an inconsistency and something that is, again, likely to have given rise to many of the criticisms of the Commission's action. The Commission further stated that it was inopportune for it to act now while the ABA is at work on the revision of its Code of Professional Responsibility, thus leaving open the notion that it would pass judgment on the ABA's proceedings after the fact. In addition, the Commission said that rules would prove counterproductive by stifling the flow of communication between attorneys and corporate employees, which is something that I think most attorneys have been sensitive to. Finally, the Commission said that the requirement that there be disclosure of attorney resignation might invade the attorney-client privilege, and worse, inhibit needed changes in counsel.

The aftermath of the SEC's denial of the two petitions leaves us with two questions. One, what would happen if the Commission is not satisfied with the work of the ABA or otherwise decides to proceed? Secondly, what are the views of the existing commissioners? As to the latter question, on April 30, approximately two weeks after the Commission denied the November petition, Commissioner Evans gave a speech before the Chicago Bar Association, captioned Investor Protection and the Securities Bar. The speech purported to elaborate in part on the SEC's denial of the petition and it reasserted some of the views that have permeated earlier Rule 2(e) proceedings that the Commission had conducted. In effect, there were eight reasons articulated why the SEC could, should and would ensure that securities lawyers "are guided by appropriate standards of professional conduct." The eight include: (1) the erosion of private rights of action in the Supreme Court; (2) the limited SEC enforcement staff; (3) the increased use of soft information in filings with the SEC even though it is the SEC that has been encouraging the use of soft information in filings; (4) escalating public expectations of securities lawyers which Commissioner Evans mentions is evidenced by the May and November petitions; (5) the impact of legal opinions as a means of access to the securities market; (6) the public expectation that the SEC would ride herd over securities lawyers (this I might uncharitably refer to as a Catch 22, that is, the more we do it, the more it is assumed we will do it, and therefore, the more we have to do it); (7) the integrity of the SEC's own processes, a theory that was expressly sustained by the Court of Appeals for the Second Circuit in the *Touche Ross*<sup>7</sup> case, with respect to accountants; and (8) the failure of State Bar Associations to do their best to control, monitor and discipline securities lawyers, a source of recurring problems for the Commission. Commissioner Evans also made the same caveat, namely that the Commission would continue to monitor developments and continue to bring enforcement cases to

5. [1979-80 Trans. Binder] Fed. Sec. L. Rep. (CCH) § 82,501.

6. *Id.* at 83,112.

7. *Touche Ross & Co. v. SEC*, 609 F.2d 570 (2d Cir. 1979).

supplement the Commission's other activities. Commissioner Evans also said that he personally was sympathetic to the supplemental petition and that if timely and adequate progress was not made he personally believed that the SEC should *sua sponte* revisit the petition and raise the issue itself.

In my view, the requirement in the May petition that the lawyer may have to go beyond the client if the client does not appropriately rectify the situation after being alerted of the possible fraud, is not within the ambit of the SEC's authority. However, I recognize that the Commission can make arguments on its behalf, especially if you start with the assumption that the Commission has authority to adopt a rule like Rule 2(e). At this point I would state that I think the issue is far from clear in favor of those who argue that the Commission lacks authority. But, I also think that the Commission may lose much of the ground it has built up in its administrative decisions when the issue is tested. However it is far from clear that the courts would strip the Commission of authority.

Therefore, the question is how much authority the courts will say the Commission has and in what cases should it be increased. The more egregious the case, such as the *Spectrum* case, the *Ezrine* cases, or the *Fields* cases with the opinion mills, where this issue gets raised, the more likely it is that the Commission will be able to sustain a greater portion of its Rule 2(e) authority. On the other hand, the more tenuous the case, and it would ill behoove us to discuss pending cases at the moment, the less likely it is that the Commission will be able to sustain any of its authority other than regulating contumacious conduct in an administrative proceeding. My own analysis is that the Commission is not without some authority and the extent will depend on the particular facts and circumstances. If you assume that the Commission does have basic authority of some sort, then it is a very short leap to say that it can amend this rule to define what constitutes unethical or incompetent behavior. My own view is that it is this part of the rule that is the most easily subject to attack because it seems to put the Commission in the role of defining standards for practice. There I think the Commission becomes awfully close to the line that was drawn in the Administrative Practice Act in the 1960s which says that the agencies may not establish standards for the admission of lawyers to practice before the agencies.

Indeed, if one accepted this theory of an amendment to Rule 2(e), there would be no limit on the SEC's authority. It need not stop simply with the device of calling frauds to the client's attention. It presumably could supplant any and all ABA and local bar association authority which, in my judgment, is an absurd result. Alternatively, the SEC might be able to argue that for purposes of Rule 10b-5 or any other disclosure requirements under the federal securities laws, that the agency can spell out what will or will not constitute the omission of a material fact. To use the SEC's own words, this attenuation would permit the SEC to govern all corporate internal conduct.

The November petition is more difficult. And I think that therein lies the nub of the problem. One thing, and I think the easiest and the most readily attackable element, is the requirement that the board tell all attorneys to report actual or probable violations of law. This looks like an affirmative governance requirement that is outside of the Commission's authority. However, the Commission conceivably could define its reporting requirements to include reports of illegal conduct. Thus, the SEC could require a counsel certificate of that on a disclosure basis or the failure to have obtained the counsel certificate, which would go a long way to give the Commission some handle over this. Again, the Commission has not suggested this. It would be troublesome if it attempted to pursue this. But the November petition, although it is rejected, still lies around not fully buried and potentially available to rear its ugly head in some fashion if the Commission or members of it determine that they are not satisfied with the efforts of the bar. The remainder of the package, namely, the filing of instructions to counsel, the filing of all written materials and 8K amendments, while rejected for sound and appropriate reasons, seem almost unquestionably to give rise to some SEC authority. However, the invasion of the attorney-client privilege might require a court to strike down a rule proposal as being arbitrary or capricious or an abuse of discretion. Nevertheless, I think one looking at these provisions cannot walk away blithely assuming that the provisions are without any authority within the SEC. It is hoped that the SEC would not resurrect these proposals again. And if they do not intend to, it is most unfortunate that the Commission decided to leave these issues hanging.